Supreme Court, U.S.
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No. 02-

IN THE

Supreme Court of the United States

FRANK GRYL and BARBARA GRYL,
f/b/o SHIRE PHARMACEUTICALS GROUP PLC,

Petitioners,

v.

SHIRE PHARMACEUTICALS GROUP PLC,
ZOLA HOROVITZ, RONALD NORDMANN,
and JOHN SPITZNAGEL,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Securities & Exchange Commission adopted Rule 16b-3(d), 17 C.F.R. § 240.16b-3(d) to exempt from the short-swing trading prohibition of Section 16(b) of the Securities Exchange Act, 15 U.S.C. § 78p(b), issuances of securities by an issuer to its officers and directors under carefully circumscribed conditions. To be exempt such issuances must either be approved by a majority of the issuer's shareholders or of its directors or of a committee of non-employee directors (or the securities must be held for six months). Footnote 3 to the rule states that if directoral or shareholder approval is to be relied upon it "require[s] the approval of each specific transaction, and [is] not satisfied by approval of a *plan* in its entirety except for the approval of a *plan* pursuant to which the terms and conditions of each transaction are fixed in advance, such as a *formula plan*." (Emphasis added).

The terms *plan* and *formula plan* were intended by the Commission to mean employee benefit *plans*, which is to say option, bonus, employee stock purchase, profit sharing, retirement, incentive, thrift, savings or similar *plans*. The Second Circuit, without having the issue addressed by the court below, by any of the litigants before it or by the Commission appearing *amicus*, has read the terms *plan* and *formula plan* to include an agreement of merger, a meaning alien to the intendment of the Commission and disruptive nationwide of the Commission's regulatory scheme for issuances by issuers to officers and directors.

The questions presented are:

1. Should an appellate court defer to the Securities & Exchange Commission in accepting the intended meaning of terms used in its regulations, specifically Rule 16b-3(d)?

2. Should an appellate court defer to the Securities & Exchange Commission and apply the Commission's regulatory scheme as it intended for exempting from the reach of the short-swing trading prohibition issuances of securities by an issuer to its officers and directors where those regulations have in no way been challenged or questioned in the case before it?

STATEMENT PURSUANT TO RULE 29.6

Shire Pharmaceuticals Group PLC, for whose benefit this suit is brought has no parent corporation and no publicly held company owns 10% or more of its stock.

The petitioners are natural persons.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court Of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The district court's opinion (Baer, D.J.) granting respondents' motion to dismiss (Appendix ["Pet. App."] C) is published at CCH Fed. Sec. L. Rep. ¶ 91,527 (S.D.N.Y. 2001). It is not officially published. The court of appeals' opinion (Staub, Cir. J. joined by Sotomayor, Cir. J. and Goldberg, J., Ct. Of Int'l Trade) (Pet. App. B) is published at 298 F.3d 136. The appellate order denying rehearing (Pet. App. A) is not published.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on August 5, 2002, and denied rehearing on September 9, 2002. Petitioners invoke this Court's jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves a regulation of the Securities & Exchange Commission, Rule 16b-3(d), 17 C.F.R. § 240.16b-3(d), and footnotes thereto, promulgated under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b). A copy of the relevant text of the regulation appears at Pet. App. D.

STATEMENT OF THE CASE

This is a shareholder suit brought to recover, for the benefit of Shire Pharmaceuticals Group PLC, ("Shire") short-swing profits alleged to have been realized by Messrs. Horovitz, Nordmann and Spitznagel ("the individual defendants") in violation of Section 16(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78p(b).

The case involves the merger of Roberts Pharmaceuticals Corporation ("Roberts") with Shire. Pursuant to the terms of that merger the individual defendants, who were directors of Roberts prior to the merger and holders of its stock options, became directors of Shire, the time of their assumption of the latter offices being sharply disputed. Additionally, and crucial to the case, the Roberts options held by the individual defendants converted to Shire options at the moment the merger became effective. Within six months of the merger the individual defendants exercised Shire options and sold resulting shares.

It is the plaintiffs central contention in the case that the acquisition of Shire options by the Individual defendants on the merger were purchases of those options and that matching sales within six months of the merger ran afoul of the short-swing trading prohibition of Section 16(b).

Putting aside, as the appellate court did, the individual defendants' claims that the exemption available to persons prior to becoming an officer or director (Rule 16a-2(a), 17 C.F.R. § 240.16a-2(a)) and the exemption available to transactions involving a foreign private issuer (Rule 3a12-3(b), 17 C.F.R. § 240.3a12-3(b)) were available the only possible counter to the plaintiff's allegations is the exemption

provided by Rule 16b-3(d) adopted by the Securities & Exchange Commission to regulate the acquisition of securities by officers and directors from their own issuer. The latter is the only exemptive provision at issue before this Court.

Rule 16b-3(d), (Pet. App. D) requires in pertinent part that an acquisition of shares from an issuer by its officers or directors, in order to be exempt from the reach of the short-swing trading prohibition of Section 16(b), must either be approved by a majority of an issuer's shareholders or of its directors or by a committee of directors composed solely of nonemployee directors. Footnote 3 to the rule states that:

> Note (3): The approval conditions of Paragraphs (d)(1), (d)(2) and (e) of this section require the approval of each specific transaction, and are not satisfied by approval of a *plan* [emphasis added] in its entirety except for the approval of a *plan* [emphasis added] pursuant to the terms of which the terms and conditions of each transaction are fixed in advance, such as a *formula plan* [emphasis added]. Where the terms of a subsequent transaction (such as the exercise price of an option, or the provision of an exercise or tax-withholding right) are provided for in a transaction as initially approved pursuant to paragraphs (d)(1), (d)(2) or (e), such subsequent transactions shall not require further specific approval.

17 C.F.R. § 16b-3, Note 3

Neither the district court in its opinion (Pet. App. C) nor the litigants in their briefs or arguments before the district court or the appellate court nor the Securities & Exchange Commission in its *amicus* brief on appeal gave the slightest attention to the provisions of note 3 for *plans* or *formula plans* for the simple reason that they relate to matters in no way relevant to the facts of the case.

The appellate court based its affirmance of the judgment of dismissal on its declaration that the merger agreement contained a "formula plan" for the conversion of Roberts options into Shire Options. In doing so it simply misapprehended the meaning and defining characteristics of a *plan* and of a *formula plan* as those terms are used in Rule 16b-3, Note 3 and, on petitioner's application for rehearing, it declined petitioner's request to permit the Securities & Exchange Commission to address the issue.

THE CONVERSION OF ROBERTS OPTIONS INTO SHIRE OPTIONS UPON THE MERGER WAS A "ONE SHOT" EVENT WHICH CANNOT QUALIFY EITHER AS A PLAN OR AS A FORMULA PLAN UNDER THE DEFINITIONS OF THOSE TERMS AND SECURITIES & EXCHANGE COMMISSION INTERPRETATIONS OF ITS OWN RULES

The only mention of the term "formula plan" at any time in the conduct of the case prior to appellate decision was Judge Staub's reference at oral argument to the conversion of options in the merger as a formula plan and the response of petitioner's counsel that what was before the court was simply not a formula plan because formula plans were forms of employee benefit plans with fixed grant criteria. The issue was not further pursued. It then reappeared as the principal basis for the appellate court's decision.

A. The Securities & Exchange Commission Has Expressly Adopted The Pre-1996 Interpretations Of Its Staff To Define "Formula Plans"

The term "formula plan" arose under former Rule 16b-3 (c)(2)(ii)(A), 17 C.F.R. § 16b-3(c)(2)(ii)(A) (in effect 1991-1996) which stated that an employee benefit plan would qualify as a formula plan if it either: (a) stated the amount, price and timing of awards to designated officers and directors or categories thereof; or (b) prescribed a formula for determining on the basis of objective criteria, the amount, price and timing of awards to such persons. *See* Jacobs, *Section 16 of the Securities Exchange Act*, Sec. 3.75 at pp. 3-463 to 3-465.

The Commission, in Ownership Reports & Trading by Officers, Directors & Principal Security Holders, Exchange Act Release No. 34-37260, 1996-1997 CCH Transfer Binder, Fed. Sec. L. Rep. (CCH) Par. 85,810 at 88,065, (May 31, 1996) [hereinafter 1996 Release] at n.71. stated that "A plan that constitutes a 'formula plan' under staff interpretations of current Rule 16b-3(c)(2)(ii) will be considered a formula plan for this purpose." The purpose to which the Commission referred was the approval needed to comply with newly promulgated Rule 16b-3(d), Note 3, where the form of approval relied upon for exemption was to be ". . . approval of a plan pursuant to which the specific terms and conditions of each acquisition are fixed in advance, such as a formula plan."

By incorporating staff interpretations into its promulgating release for definitional purposes the Commission removed those interpretations from the realm of "entitlement to no deference beyond whatever persuasive value they might have", *see Morales v. Quintel Entertainment Inc.*, 249 F.3d 115, 129 (2d Cir. 2001); *N. Y. City Employees' Ret. Sys. v. SEC*, 45 F.3d

7, 13 (2d Cir. 1995); *Amalgamated Clothing & Textile Workers Union v. SEC*, 15 F.3d 254, 257 (2d Cir. 1994), and made those interpretations an authoritative aid to understanding the meaning of the term as used in Rule 16b-3. As such they are entitled to great deference.

B. For There To Be A "Formula Plan" There Must First Be A "Plan".

Pre-1991 Rule 16b-3(d)(1) defined "plan" to mean "an option, bonus, employee stock purchase[1], appreciation, profit sharing, retirement, incentive, thrift, savings or similar plan" which: (1) sets forth in writing the means or basis for determining an individual's eligibility to participate and either the price at which securities can be offered or the method of determining the price or the amount of the award; and (2) provides that options and similar rights are non-transferable other than at death or pursuant to a qualified domestic relations order and are exercisable during the optionee's lifetime only by the optionee or his or her legal representative. *See generally* Jacobs, *Section 16 of the Securities Exchange Act*, Sec. 3.72 at pp. 3-450 to 3-453.

A "formula plan" was defined by Rule 16b-3(c)(2)(ii) (1991-1996 Version) to be:

> (ii) *Formula Awards*. The grantor award is made pursuant to a *plan* [emphasis added] that by its terms:
>
> > (A) permits officers and/or directors to receive awards; either states the amount

1. Although the text of the rule did not include stock purchase plans they were included through interpretation. *See* Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 3418114 at Q. 111 (September 23, 1981.)

> and price of securities to be awarded to designated officers and director or categories of officers and directors, though not necessarily to others who may participate in the *plan* [emphasis added], and specifies the timing of awards to officers and directors; or sets forth a formula that determines the amount, price and timing, using objective criteria such as earnings of the issuer, value of the securities, years of service, job classification, and compensation levels; and
>
> (B) provides that these *plan* [emphasis added] provisions shall not be amended more than once every six months, other than to comport with changes in the Internal Revenue Code, the Employee Retirement Income Security Act, or the rules thereunder."

Examples of formula plans approved in SEC No-Action or interpretive letters or in interpretive releases (and thereby incorporated by reference in the 1996 Release) include:

i) A broad-based, noncontributory, tax-qualified stock bonus plan that allocates stock to the accounts of participants automatically in proportion to their compensation (*Joseph A. Grundfest*, August 19, 1991, Q. 8);

ii) A broad-based, noncontributory, tax-qualified ESOP (*Thompson, Hine & Flory*, March 29, 1991, Q.3);

iii) A broad-based, noncontributory, tax-qualified profit-sharing plan (*Southwest Airlines Co.*, July 17, 1991);

iv) A plan open to all employees which prescribes eligibility and allocation criteria that are fixed and uniform for all participants (Release No. 34-18114, Q. 106(a) (1981);

v) A plan not in compliance with Rule 16b-3 which provides for formula awards to directors for purposes of their administering other, separate plans of the issuer (*Dinsmore & Shohl*, April 26, 1991, Q. 1);

vi) A plan under which formula grants are made to directors and discretionary grants to other insiders (*Bingham, Dana & Gould*, April 10, 1991);

vii) A plan which provides for grants of securities on fixed terms to a defined class of recipients (e.g., Non-employee Directors) on an ongoing basis without discretion by any third party (*Frederick W. Cook & Co. Inc.*, July 3, 1991; *See also Merck & Co. Inc.*, January 16, 1992; *Intervoice, Inc.*, November 27, 1991);

viii) A stock option plan under which each Non-employee Director automatically will receive an option to purchase a fixed number of shares on a specific date or dates (*Merck & Co. Inc.*, January 16, 1992);

ix) A stock option plan under which each Non-employee Director automatically will receive an option to purchase a fixed number of shares upon initial election and options to purchase a smaller number of shares annually thereafter (*Boeing Co.*, December 20, 1991);

x) A stock option plan under which each Non-employee Director automatically will receive an option to purchase a fixed number of shares upon initial election and each re-

election unless the director elects six months in advance not to receive an option (*Teradata Corp.*, November 20, 1991);

xi) A stock option plan under which each Non-employee Director who is a resident of the issuer's home country automatically will receive an option to purchase a fixed number of shares once every five years on a nonelective basis (*Manpower, Inc.*, May 7, 1992, Q.A.3);

xii) A stock option plan which provides for an annual grant to each Non-employee Director of an option to purchase a fixed number of shares, but prescribes different lifetime ceilings on total grants to such person depending on when they were first elected to the board (*Clothesline, Inc.*, May 13, 1992);

xiii) A stock option plan which provides for an annual grant to each Non-employee Director of an option to purchase a number of shares based on a formula that takes into account the number of years of continuous service by the director (*Kent Electronics Corp.*, December 20, 1991);

xiv) A stock option plan which provides for an annual grant to each Non-employee Director of an option based on the annual retainer fee, provided the director has held a specified minimum number of issuer shares during the period beginning on the date of the previous year's annual meeting and ending on the date of the current year's annual meeting (*Echo Bay Mines, Ltd.*, April 14, 1994);

xv) A restricted stock plan under which each Non-employee Director automatically will receive 20 percent of the value of his or her annual retainer in the form of restricted stock (*Adolph Coors Co.*, October 28, 1991);

xvi) A plan which provides that Non-employee Directors, in lieu of their annual cash retainers, will receive automatic grants pursuant to a formula of restricted stock to be distributed when they leave the board (*NUI Corp.*, December 9, 1991, Q.3);

xvii) A plan under which Non-employee Directors receive annually on a prescribed date a fixed number of shares pursuant to a standing resolution of the board of directors (*Phillips Petroleum Co.*, June 6, 1991).

The plan which the appellate court mis-identified as a "formula plan" is the plan of merger. A plan of merger simply is not within the contemplation of a "plan" — meaning an employee benefit plan — as defined in the former rule or as used in the staff interpretations expressly incorporated in the 1996 Release which promulgated Rule 16b-3. There are neither precedents, legislative history nor policy considerations for it to be otherwise.

C. A Formula Plan Must Be Ongoing In Nature And Cannot Be A One-Shot Grant Of Options To Directors.

Staff interpretations of former Rule 16b-3(c)(2)(ii) were unequivocal in requiring that for there to be a "formula plan" there must be a plan that is ongoing in nature. One-off grants to directors do not qualify. *Torreador Royalty Corp.* (March 6, 1992); *Dinsmore & Shohl* (April 26, 1991) (Q.2). The duration of the plan must be such that an award is not tantamount to a one-shot or one-installment grant, although a plan need not run in perpetuity to be treated as ongoing. *Frederick W. Cook & Co. Inc.*, (July 3, 1991).

As a leading commentator on the statute has observed, "In essence, if grants are to be made to current directors there must be periodic ongoing awards to future directors under the same objective terms without discretion exercised by any third party." Romeo and Dye, *Comprehensive Section 16 Outline*, p. 357.

The merger agreement cannot fulfill this requirement of a formula plan because its power to grant options to the former directors of Roberts was a once-only event. The exchange of Roberts options for Shire options was to take place at the moment of consummation of the merger and never again. It was characterized by what the staff interpretations say a formula plan cannot have — a lack of continuity and a lack of potential coverage of other persons in the future.

Examples of formula plans, as considered ongoing by the Commission, include:

i) A plan providing for grants to all current directors and identical grants to all new directors as each becomes a director in the future (*Frederick W. Cook & Co. Inc., supra*);

ii) A plan providing for a three-year installment grant to each outside director and to all future outside directors (*Intervoice, Inc.*, November 27, 1991);

iii) A plan providing for initial grants to all current directors and subsequent equal grants to each director when that person is elected or reelected to the board (*Frederick W. Cook & Co., Inc., supra*);

iv) A plan providing for grants over the next five years with each grant effective as of the close of the issuer's fiscal year (*Frederick W. Cook, Inc., supra*);

v) A plan providing for annual grants to each non-employee director pursuant to a formula that is based in part on the number of years of continuous service of the director (*Kent Electronics Corp.*, December 20, 1991).

D. If A Merger Agreement, By Inclusion Of A Provision For The Conversion Of Options, Is Treated As A Formula Plan, The Regulatory Framework Created By The Commission Is Dismantled.

The Commission, in Rule 16b-3(d), has provided a carefully crafted regulatory scheme for the exemption of acquisitions by insiders of shares from their issuers. By means of the interpretive advice contained in *Skadden Arps Slate Meagher & Flom L.L.P.*, SEC No-Action Letter [1999 Transfer Binder], Fed. Sec. L.Rep. (CCH) Par. 77,515 at 78,565-66 (Jan. 12, 1999) the coverage of Rule 16b-3(d) was extended to grants of shares or options by an acquirer in the course of a merger or business combination, a result not otherwise deducible from the text of the rule. That text provides solely for the exemption of "Grants, Awards and Other Acquisitions From the *Issuer*" (Roberts). Absent the *Skadden Arps* interpretive letter it does not cover grants by the acquirer (Shire).

It is because the rule was not written with acquirer grants in mind that the terminology used continues to be largely that appropriate to regulation of issuer grants through employee benefit plans. The appellate court, through misapprehension of the meaning of two terms having

specialized meaning in the context of the rule — "plan" and "formula plan" — goes far to upset that regulatory scheme, seemingly through inadvertence and unawareness, without having solicited or had the benefit of the views of the litigants or of the Commission on the specific point of decision.

REASONS FOR GRANTING THE PETITION

The requirement of Note 3 to the Rule 16b-3(d) that there be "approval of each specific transaction" which is "not satisfied by approval of a plan in its entirety" is rendered a nullity by the appellate court's misinterpretation of the "formula plan" exception. Through misapprehension the exception has been made to engulf the rule. The gate-keeping function the rule was intended to impose on corporate governance effectively is annulled.

The Second Circuit's judgment, as a practical matter, creates a national rule which removes the Securities & Exchange Commission from the regulation and exemption of short-swing trading through the acquisition by insiders of securities in mergers or corporate combinations. The careful formulation of a procedure by which such acquisitions can be considered and approved or disapproved on an individual basis by directors or shareholders is cancelled, seemingly by inadvertance. The explicit rule of the Commission that blanket approvals are inadequate is simply cancelled without the Commission being given a voice on the specific question or a reasoned basis for the change being enunciated by the appellate court.

Regulation of the securities markets is the province, in the first instance, of the Commission. The greatest deference is to be given to the Commission's interpretations of its own rules. The Second Circuit has stated that it:

> . . . is bound by the SEC's interpretations of its regulations in its *amicus* briefs, unless they are plainly erroneous or inconsistent with the regulation[s]." *Levy v. Southbrook International Investments, Ltd.*, 263 F.3d 10, 15 (2d Cir., 2001), cert. denied, 122 S. Ct. 1911 (2002), (quoting *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000), citing *Auer v. Robbins*, 519 U.S. 452, 461-63 (1997).

To the extent the Commission is construing an ambiguous statutory provision, its construction, if reasonable, is entitled to deference. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984); *City Of New York v. Minetta*, 262 F.3d 169, 177 (2d Cir. 2001).

In adopting Rule 16b-3(d), including Note 3, the Commission was exercising its powers and responsibilities to implement Section 16(b) in a reasonable and workable manner. For an appellate court to interpret the provision through misapprehension of the meaning of key terms so as to make them and it accomplish the opposite of what the Commission intended is hardly deferential. To decline to have the Commission (let alone the litigants) state its own views before dismantling a regulatory framework of some importance and complexity borders on the gratuitous. Declining to have the Commission express its views on the specific issue of decision is not an appropriate way for an appellate court to sidestep its obligation of deference.

Merger and acquisition activity among public companies is inherently national in scope, affecting shareholders and issuers wherever in this country they may be found. The Second Circuit in its panel decision has gone a far way down the road to casting the application of Section 16(b) in such transactions into confusion and the Securities & Exchange Commission's oversight pronouncements into doubt when they are most needed.

CONCLUSION

The appellate court fundamentally misapprehended the meaning of two terms used in Note 3 to Rule 16b-3(d) — "plan" and "formula plan". The result is to undercut the Securities & Exchange Commission's credibility in its pronouncements at a time when the authoritativeness of its regulatory efforts is greatly needed. This petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR PANEL REHEARING DATED AND FILED SEPTEMBER 9, 2002

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

ROSEANN B. MACKECHNIE
CLERK

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 9th day of September two thousand two.

Present:

Hon. Chester J. Straub,

Hon. Sonia Sotomayor,

CIRCUIT JUDGES

Hon. Richard W. Goldberg*,

U.S. Court of Int'l Trade

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* The Honorable Richard W. Goldberg of the United States Court of International Trade, sitting by designation.

Appendix A

Docket No. 01-9139

Gryl, et al.

Plaintiffs-Appellants,

v

Shire Phar. Group, et al.,

Defendants-Appellees.

A petition for panel rehearing having been filed herein by Appellants Frank and Barbara Gryl.

Upon consideration thereof, it is

Ordered that said petition be and it hereby is **DENIED.**

FOR THE COURT
ROSEANN B. MACKECHNIE, Clerk

By: s/ Arthur M. Heller
Arthur M. Heller
Administrative Attorney

APPENDIX B — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND FILED AUGUST 5, 2002

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2001

(Argued: May 30, 2002
Last Supplemental Briefs Filed July 12, 2002
Decided August 5, 2002)

Docket No. 01-9139

FRANK GRYL, for the benefit of Shire Pharmaceuticals Group PLC and BARBARA GRYL, for the benefit of Shire Pharmaceuticals Group PLC,

Plaintiffs-Appellants,

—v.—

SHIRE PHARMACEUTICALS GROUP PLC, ZOLA HOROVITZ, RONALD NORDMANN and JOHN SPITZNAGEL,

Defendants-Appellees.

Before:

STRAUB, SOTOMAYOR, *Circuit Judges*,
and GOLDBERG, *Judge*.*

---

* The Honorable Richard W. Goldberg, Judge of the United States Court of International Trade, sitting by designation.

Appendix B

Appeal from judgment of the United States District Court for the Southern District of New York (Harold Baer, Jr., *Judge*) dismissing the complaint for failure to state a claim upon which relief can be granted. The District Court found that the individual defendants' short-swing securities transactions were exempt from liability under Section 16(b) of the 1934 Securities Exchange Act. We affirm on the basis of Rule 16b-3(d)(1), the exemption for issuer-to-insider transactions approved by the issuer's board of directors.

STRAUB, *Circuit Judge*.

Plaintiffs-Appellants Frank and Barbara Gryl, suing on behalf of Nominal Defendant Shire Pharmaceuticals Group PLC ("Shire"), seek to compel the disgorgement of short-swing profits realized through the acquisition and sale of Shire securities by Defendants-Appellees Zola Horovitz, Ronald Nordmann and John Spitznagel (the "individual defendants"). The plaintiffs are shareholders of Shire and the individual defendants serve on Shire's board of directors. This derivative suit is actionable pursuant to Section 16(b) of the 1934 Securities Exchange Act, which provides in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by . . . [a] director . . . by reason of his relationship to the issuer, any profit realized by him from any purchase and sale . . . of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part

> of such . . . director . . . in entering into such transaction. . . . Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction ... by the owner of any security of the issuer in the name and in behalf of the issuer. . . .

15 U.S.C. § 78p(b).

The United States District Court for the Southern District of New York (Harold Baer, Jr., *Judge*) dismissed the complaint after determining that the individual defendants' receipt and sale of Shire securities, despite having wholly occurred within a period of less than six months, nonetheless fell within three different exemptions to Section 16(b)'s prohibition against short-swing profit taking by issuer insiders. For the reasons set forth below, we affirm the judgment of the District Court based on Rule 16b-3(d)(1), the exemption for issuer-to-insider transactions approved by the issuer's board of directors.

BACKGROUND

The securities transactions that are the subject of this lawsuit are rooted in a corporate merger wherein Roberts Pharmaceutical Corporation ("Roberts") became a wholly-owned subsidiary of Shire (the "Merger").[1] Prior to the Merger—which became effective at 9:30 a.m. on December 23, 1999—the individual defendants were stock option

1. The Merger was effected by a stock swap; each outstanding common share of Roberts stock was converted into a specified quantity of Shire stock.

holders and directors of Roberts. One of the changes wrought by the Merger was that the individual defendants became directors of Shire, although the parties dispute whether that event technically occurred instantaneously with or subsequent to the Merger. Additionally, the Agreement and Plan of Merger Among Shire and Roberts (the "Merger Agreement") called for all existing Roberts stock options to be automatically converted into Shire options at the moment the Merger became effective:

> [At the Effective Time,] Shire shall assume or replace such Options (or fraction thereof) so that each holder of an Option (an "Optionee") shall have such Optionee's Option apply to that number of Ordinary Shares (adjusted to the nearest whole share) equal to the product of (i) the number of all Options of such Optionee immediately prior to the Effective Time and (ii) the Exchange Ratio. The exercise price per share for each Optionee's Options (adjusted to the nearest pence) assumed or replaced will equal the old exercise price per share of Common Stock divided by the Exchange Ratio. . . . Without limiting the foregoing, the duration and other terms of each assumed or replaced Option immediately after the Effective Time . . . shall be the same as the corresponding Options that were in effect immediately before the Effective Time, except that all references to Roberts in the Roberts Option Plans (and the corresponding references in each option agreement documenting each such Option) shall be deemed to be references to Shire or the Surviving Corporation, as applicable. . . .

Merger Agreement art. VI, ¶ 6.1(a). It is undisputed that less than six months after acquiring their converted Shire options, each of the individual defendants exercised all or a portion thereof and sold those shares for a profit.

The plaintiffs filed this stockholder derivative action on December 4, 2000, in the United States District Court for the Southern District of New York. Pursuant to Section 16(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78p(b), the plaintiffs sought to compel the individual defendants to disgorge profits realized through the short-swing sale of Shire shares.

The individual defendants moved on March 9, 2001, to dismiss the complaint for failure to state a claim upon which relief can be granted. They argued that the securities transactions in question qualified for three separate exemptions to Section 16(b) liability: (1) Rule 16a-2(a)—the exemption for transactions by a person prior to his becoming an officer or director of the issuer, 17 C.F.R. § 240.16a-2(a); (2) Rule 3a12-3(b)—the exemption for transactions involving securities of a foreign private issuer, 17 C.F.R. § 240.3a12- 3(b); and (3) Rule 16b-3(d)(1)—the exemption for issuer-to-insider transactions approved by the issuer's board of directors, 17 C.F.R. § 240.16b-3(d)(1). The individual defendants also contended that receiving converted stock options as a result of a merger does not constitute the "purchase" of a security within the meaning of Section 16(b).

Oral argument on the motion to dismiss was held on June 26 and July 26, 2001. In a written decision dated August

30, 2001, the District Court agreed that the individual defendants were exempt from Section 16(b) liability under all three of the exemptions raised, but declined to determine whether the acquisition of converted stock options during a merger constitutes the "purchase" of a security covered by Section 16(b).

The plaintiffs appeal the District Court's ruling as to the applicability of all three exemptions to Section 16(b) liability, while the individual defendants reassert their argument concerning the meaning of "purchase" under Section 16(b). Because each of the three exemptions is an independent ground for dismissing the complaint, we affirm the dismissal based solely on Rule 16b-3(d)(1), the exemption for issuer-to-insider transactions approved by the issuer's board of directors. In so doing, we express no opinion in respect of the other two exemptions relied upon by the District Court and we assume, but do not decide, that receiving converted stock options in the context of a merger amounts to the "purchase" of a security as required for Section 16(b) liability.

DISCUSSION

We review *de novo* a district court's grant of a motion to dismiss a complaint made pursuant to Federal Rule of Civil Procedure 12(b)(6). *See York v. Ass'n of the Bar of the City of N.Y.*, 286 F.3d 122, 125 (2d Cir. 2002). In assessing the sufficiency of the complaint, we must accept the allegations contained therein as true and draw all reasonable inferences therefrom in favor of the plaintiff. *See King v. Am. Airlines, Inc.*, 284 F.3d 352, 356 (2d Cir. 2002). We are also free to consider documents that are incorporated into the complaint

by reference or attached to the complaint as exhibits, or whose terms and effect are relied upon by the plaintiff in drafting the complaint. *See Chambers v. Time Warner, Inc.*, 282 F.3d 147, 152-54 (2d Cir. 2002). "Dismissal is inappropriate unless it appears beyond doubt that the plaintiff can prove no set of facts which would entitle him or her to relief." *Sweet v. Sheahan*, 235 F.3d 80, 83 (2d Cir. 2000).

The issue we consider on appeal is whether, by operation of Rule 16b-3(d)(1), the individual defendants' acquisition and sale of Shire securities is exempt from Section 16(b) of the 1934 Securities Exchange Act and its ban against short-swing profit taking by issuer insiders. Rule 16b-3(d)(1) provides, in relevant part, that any issuer-to-insider transaction "involving a grant, award or other acquisition" of issuer equity securities shall be exempt from Section 16(b) liability if the transaction is "approved by the board of directors of the issuer." 17 C.F.R. § 240.16b-3(d)(1). Accordingly, there are three requirements for a securities transaction to qualify for what we hereinafter refer to as the "Board Approval Exemption":

(1) The transaction must involve the defendant acquiring issuer equity securities from the issuer;

(2) The defendant must be a director or officer of the issuer at the time of the transaction; and

(3) The transaction must be approved in advance by the issuer's board of directors.[2]

We examine each element of the Board Approval Exemption in turn.

I. *Acquisition of Issuer Equity Securities From the Issuer*

Here, all of the individual defendants received Shire stock options as part of the Merger. Although each option only gave its holder the right to receive from Shire a pre-determined number of shares of Shire stock, for purposes of the rules promulgated under Section 16(b) the acquisition of a securities option is deemed to be equivalent to the acquisition of the security underlying that option. *See* Ownership Reports & Trading by Officers, Dirs. & Principal Sec. Holders, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,258 (Feb. 21, 1991) [hereinafter 1991 Release].

II. *Issuer-to-Insider Transaction*

According to the plaintiffs' own factual allegations, which are accepted as true on a motion to dismiss, the individual defendants became Shire directors at the same time they received their Shire options. Compl. ¶ 16. Indeed, such

2. In lieu of approval by the issuer's full board of directors, Rule 16b-3(d)(1) permits approval by "a committee of the board of directors that is composed solely of two or more Non-Employee Directors." 17 C.F.R. § 240.16b-3(d)(1). That aspect of the Board Approval Exemption is not at issue in this appeal.

an allegation is crucial to the plaintiffs' derivative suit against the individual defendants because, with the exception of one circumstance not relevant here,[3] Section 16(b) liability does not extend to individuals who were neither directors nor other insiders of the issuer when they acquired their issuer equity securities. *See* 15 U.S.C. § 78p(b).

III. *Approval by the Issuer's Board of Directors*

Where there are multiple securities transactions involved, as here, the text of Rule 16b-3(d)(1) does not mandate that the issuer's board of directors approve each individual transaction separately. Rather, it is sufficient if the board approves the overall plan of which the subject transactions are but a constituent part, so long as the plan approved is one "pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan." 17 C.F.R. § 240.16b-3 note 3.

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3. Rule 16a-2(a) sets forth the single circumstance in which an individual can be held liable for short-swing transactions conducted prior to his becoming an officer or director of the issuer. *See* 17 C.F.R. § 240.16a-2(a) ("A transaction(s) carried out by a director or officer in the six months prior to the director or officer becoming subject to section 16 of the [1934 Securities Exchange] Act shall be subject to section 16 of the Act . . . only if the transaction(s) occurred within six months of the transaction giving rise to the Form 4 filing obligation and the director or officer became subject to section 16 of the Act solely as a result of the issuer registering a class of equity securities pursuant to section 12 of the Act.").

Appendix B

A. *The Formula Plan*

For guidance as to the manner in which a formula plan under the Board Approval Exemption should fix in advance the terms and conditions of its constituent securities transactions, the Securities and Exchange Commission ("SEC") release accompanying the promulgation of Rule 16b-3(d)(1) points to former Rule 16b-3(c)(2)(ii). *See* Ownership Reports & Trading by Officers, Dirs. & Principal Sec. Holders, Exchange Act Release No. 34-37260, 61 F.R. 30,376, at 30,381 n.71 (June 14, 1996) [hereinafter 1996 Release]. That former rule defined a formula plan as the grant or award of securities "made pursuant to a plan that by its terms . . . sets forth a formula that determines the amount, price and timing, using objective criteria." 17 C.F.R. § 240.16b-3(c)(2)(ii) (amended Aug. 15, 1996). A formula plan must be sufficiently prescriptive in order "to prevent insiders from having, directly or indirectly, any control over the terms of their own awards, and therefore removes the ability of the insiders to time their acquisitions under the plan to take advantage of inside information." 1991 Release at 81,269.

Formula specificity further serves the goal, urged by the SEC as *amicus curiae,* of ensuring that the approving board gives due consideration to the securities transactions that will subsequently flow out of the formula plan, thereby evincing "acknowledgment and accountability" by the board as to its own actions. SEC Amicus Br. at 24 (internal quotation marks omitted). Of course, whether the formulae set forth in a given plan are adequately specific turns on the overall corporate context served by the plan's grant or award of securities.

Appendix B

Are the securities being awarded solely as a form of special compensation to a limited number of highly influential insiders? Or are the securities instead being granted to all eligible option holders, without regard to status, as a means of fully effecting an overarching, value-adding corporate event (e.g., a merger)? Clearly, the latter scenario presents a diminished risk that the securities grants are not motivated by a legitimate corporate purpose and, as such, should generally require less in the way of formula specificity.

In respect of the securities transactions at issue in this case, we find that Article VI, Paragraph 6.1(a) of the Merger Agreement encapsulated the formula plan required for purposes of the Board Approval Exemption. All of the relevant terms and conditions of the Roberts-Shire option conversion were fixed within that single passage:

- Who? All holders of Roberts options.
- What do they receive? Shire options.
- When? At "the Effective Time" of the Merger and "without any action on the part of the [Roberts option] Holders."
- In what quantity? An amount equal to the product of (1) the number of Roberts options held by the option holder immediately prior to the merger and (2) a stipulated exchange ratio.

- At what exercise price? A price equal to the exercise price of the old Roberts option divided by the exchange ratio.

- Under what governing terms? The duration and all other exercise terms of the converted Shire options would be identical to those of the old Roberts options.

In the detailed and prescriptive manner demanded of formula plans under former Rule 16b-3(c)(2)(ii), the option conversion provisions contained in Article VI, Paragraph 6.1(a) of the Merger Agreement left Roberts option holders no discretion unilaterally to alter in their favor the amount, price, timing and exercise terms of the impending option conversion.[4] Far from being open-ended, the Merger Agreement precisely delimited the securities grants that the individual defendants would ultimately receive on the effective date of the Merger.

The plaintiffs object that the Merger Agreement's formula plan failed to spell out the full names of all the

4. Our conclusion is in no way affected by the plaintiffs' contention that, prior to the effective date of the Merger, there existed the possibility that a Roberts option holder could have exercised all or some of his Roberts options, thereby *decreasing* the total number of Shire options he would have been entitled to receive. Such a scenario would not alter the option conversion plan to the detriment of Shire because the *maximum* number of Roberts options to be converted by Shire was fixed in the Merger Agreement. *See* Merger Agreement art. IV, § 4.2 ("Until the Effective Time . . . Roberts shall not . . . authorize or issue . . . any Equity Equivalents [e.g., stock options]. . . .").

individuals holding Roberts options prior to the Merger, the exact quantity of Roberts options held separately by each such person, and the actual exercise terms governing the Roberts options. *Cf.* Skadden, Arps, Slate, Meagher & Flom L.L.P., SEC No-Action Letter [1999 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 77,515, at 78,565-66 (Jan. 12, 1999) [hereinafter Skadden No-Action Letter]. However, while we agree that listing such minutiae would not be *inconsistent* with the Board Approval Exemption, all-encompassing precision is not mandatory in every application of the exemption. This is particularly so where, as here, the three "missing" pieces of information were not free-floating variables manipulable by the future beneficiaries of the Roberts-Shire option conversion.

Whether or not separately identified in the formula plan, *all* holders of Roberts options at the moment of the Merger would receive converted Shire options—and the Shire board, by approving the formula plan, would so be aware. Whether or not quantified according to individual holdings, *all* extant Roberts options would be converted—and, again, the Shire board would so be aware. Finally, whether or not reprinted verbatim in the Merger Agreement, the terms previously governing the Roberts options would *still* govern the converted Shire options—and, as before, the Shire board would so be aware.

B. *Conditional & Purpose Non-Specific Approval*

Having concluded that the Merger Agreement contained an appropriate formula plan, we must now decide whether the Merger Agreement received the requisite board approval.

Appendix B

That the full Shire board approved the Merger Agreement is made clear from a public document that the plaintiffs concede they relied upon in drafting their complaint. On November 22, 1999, Shire filed with the SEC its Form F-4 Registration Statement Under the Securities Act of 1933 (the "Registration Statement"), appended to which was a copy of the executed Merger Agreement. Within the body of the Registration Statement was a point-by-point summary of the Merger Agreement, including a description of the option conversion plan that mirrored Article VI, Paragraph 6.1(a) of the Merger Agreement.[5] As for the Shire board's approval of the Merger Agreement, the Registration Statement stated that

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5. The Registration Statement summarized the option conversion plan as follows:

> At the effective time, Shire will assume each of Roberts' stock option plans and all options will be adjusted so that each holder of an option will have such option apply to that number of ordinary shares (adjusted to the nearest whole share) equal to the product of the number of all options of such optionee immediately prior to the effective time and the exchange ratio. The exercise price per share for each option assumed, adjusted to the nearest pence, will equal the old exercise price per Roberts share divided by the exchange ratio. . . . The duration and other terms of each assumed or replaced option immediately after the effective time will be the same as the corresponding options that were in effect immediately before the effective time.

Registration Statement at 68.

> on July 22, 1999, the Shire board met to discuss the merger, the terms of the merger agreement and the proposed exchange ratio. . . . The Shire board then approved the merger agreement . . . , contingent upon approval of a special committee. . . .

Registration Statement at 48-49. The Registration Statement was signed by all of Shire's directors. *See id.* at II-5.

The plaintiffs do not challenge the factual accuracy of the Registration Statement, nor do they dispute that the Shire board approved the Merger Agreement on July 22, 1999. Rather, they claim that the *nature* of the July 22 approval—as reflected in the Registration Statement—was of a type insufficient as a matter of law to invoke the Board Approval Exemption. This supposedly fatal deficiency arises from: (1) the "conditionality" of the July 22 approval in that such approval was ultimately conditioned on final approval of the Merger Agreement by a committee of the board[6] as well as final approval of the Merger by Shire's shareholders; and (2) the Shire board's failure to indicate that its approval of the Roberts-Shire option conversion was specifically for purposes of exempting the individual defendants from Section 16(b) liability. Both of the plaintiffs' arguments are unavailing.[7]

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6. It bears noting that even though the Shire board delegated the task of final approval of the Merger Agreement to a committee, the record indicates that the committee's functions were limited to pro forma administrative tasks.

7. Additionally, we summarily reject the plaintiffs' suggestion that the Board Approval Exemption does not apply here because the

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First, as observed by *amicus curiae*, once the board has approved an issuer-to-insider transaction involving a grant or award of securities, "it is irrelevant that the grant or award it approved may become final and effective only upon approval by others or the occurrence of other subsequent events." SEC Amicus Br. at 23. This is because the Board Approval Exemption "does not require that board approval be the final definitive event in the grant of securities to an officer or director." *Id.* at 22; *see also* 1996 Release at 30,380 ("If a transaction has satisfied more than one of the alternative approval conditions specified in . . . rule [16b-3(d)] . . . the issuer may rely on any condition that provides the basis of the exemption."). We thus distinguish between the multiple approval preconditions to the Merger itself—here, board, committee and shareholder approval—and the single board approval precondition to applying the Board Approval Exemption. Only the latter, which we deem satisfied, is at issue in this case.

Second, the plaintiffs contend that application of the Board Approval Exemption required the Shire board to approve the option conversion plan with an express indication that its approval was intended to invoke the exemption. Although a single SEC no-action letter superficially supports this view, *see* Skadden No-Action Letter at 78,566, the SEC in its *amicus* brief now counsels against reading a purpose-

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(Cont'd)

Shire board approved the option conversion plan in advance of the individual defendants becoming Shire directors. All that is required under Rule 16b-3(d)(1) is that the securities transaction, at the time it subsequently occurs, be between the issuer and a director or officer of the issuer. *See* Skadden No-Action Letter at 78,564-65.

specific approval requirement into Rule 16b-3(d)(1). *See* SEC Amicus Br. at 24-26. While we must defer to the SEC's interpretations of its own regulations in its amicus briefs unless they are plainly erroneous or inconsistent with the regulations, *see Levy v. Southbrook Int'l Invs., Ltd.*, 263 F.3d 10, 14 (2d Cir. 2001), SEC no-action letters constitute neither agency rule-making nor adjudication and thus are entitled to no deference beyond whatever persuasive value they might have, *see Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 129 (2d Cir. 2001); *N.Y. City Employees' Ret. Sys. v. SEC*, 45 F.3d 7, 13 (2d Cir. 1995); *Amalgamated Clothing & Textile Workers Union v. SEC*, 15 F.3d 254, 257 (2d Cir. 1994). Indeed, "[e]ven when district courts have ruled in accord with no-action letters, they almost always have analyzed the issues independently of the letters." *N.Y. City Employees' Ret. Sys.*, 45 F.3d at 13.

We find wholly unpersuasive the artificial imposition of purpose- specific approval on the Board Approval Exemption, as did the District Court and the only other court to have addressed this issue. *See Atlantic Tele-Network v. Prosser*, 151 F. Supp. 2d 633, 637-42 (D.V.I. 2000). The Skadden No-Action Letter provides neither authority nor rationale for requiring purpose-specific approval. Certainly the text of the rule itself contains no suggestion that such a requirement exists. In fact, the rule focuses singularly and objectively on requiring that the terms and conditions of the transaction receive board approval; it mentions nothing about the subjective motivations of the approving body.

Appendix B

A requirement of purpose-specific approval would run counter to the very reason why the Board Approval Exemption was established in the first place. As the SEC stated in its release accompanying the promulgation of Rule 16b-3, the provision of "a broader exemption from short-swing profit recovery for transactions between an issuer and its directors or officers . . . presented a simplified, flexible approach based on the premise that" transactions between an issuer and its directors or officers

> do not appear to present the same opportunities for insider profit on the basis of non-public information as do market transactions by officers and directors. Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute. Based on its experience with the Section 16 rules, the Commission is persuaded that transactions between the issuer and its officers and directors that are pursuant to plans . . . that satisfy other objective gate-keeping conditions, are not vehicles for the speculative abuse that section 16(b) was designed to prevent. Accordingly, these transactions are exempted by new Rule 16b-3 as adopted.

1996 Release at 30,377.[8] So long as the relevant securities transaction is between an issuer and insider, and so long as the terms and conditions of that transaction receive advance approval by the board of directors, there exists sufficient protection to ensure that any short-swing profit taking that follows is not the result of unfair market manipulation. Accordingly, we hold that a securities transaction need not receive purpose-specific approval in order to qualify for the Board Approval Exemption of Rule 16b-3(d)(1).

CONCLUSION

In conclusion, we find that Rule 16b-3(d)(1) exempts the individual defendants' acquisition and sale of Shire securities from liability under Section 16(b) of the 1934 Securities Exchange Act. The judgment of the District Court dismissing the complaint is affirmed.

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8. It is significant that, because the SEC's 1996 Release is connected to the agency's rule-making function while the Skadden No-Action Letter is not, only the former must be accorded weight by us. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984) ("[L]egislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."); *see also* 3 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 16.32[2], at 551 (4th ed. 2002) ("It must be remembered, however, that SEC no action letter responses are staff interpretations rather than formal Commission action and thus are of more limited utility than formal rulemaking or policies announced in SEC releases.").

APPENDIX C — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED AUGUST 30, 2001

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

00 CV 9173 (HB)

FRANK GRYL AND BARBARA GRYL, F/B/O SHIRE PHARMACEUTICALS GROUP PLC,

Plaintiffs,

v.

SHIRE PHARMACEUTICALS GROUP PLC, ZOLA HOROVITZ, RONALD NORDMANN and JOHN SPITZNAGEL,

Defendants.

OPINION & ORDER

HON. HAROLD BAER, JR.:

Plaintiffs Frank and Barbara Gryl ("Gryl"), shareholders of Shire Pharmaceutical Corporation ("Shire"), bring this action pursuant to Section 16(b) of the 1934 Exchange Act against Shire and three of its directors, Zola Horovitz, Ronald

Nordmann, and John Spitznagel ("defendants")[1] to disgorge the profits that the individual defendants realized when they sold their Shire shares within six months of acquiring them. The individual defendants have moved to dismiss the complaint on several grounds. First, they argue that the transactions at issue were exempt from 16(b) liability for three reasons: 1) because they were not directors of Shire when they acquired their Shire options; 2) because Shire was a foreign private issuer at the time of the transaction; and 3) because the transaction had been approved by Shire's Board of Directors. Defendants also contend that since they acquired their shares in a merger that the transaction does not constitute a "purchase" under 16(b) and, therefore, that 16(b) does not apply. For the following reasons, defendants' motion to dismiss is granted.

BACKGROUND

As I must in a motion to dismiss, I assume the truth of the facts set forth in the complaint, which are relatively simple. *See LaBounty v. Adler*, 933 F.2d 121, 123 (2d Cir. 1991) (citations omitted).

The plaintiffs are shareholders of Shire, and the individual defendants are directors of Shire. The individual defendants became directors of Shire, and acquired options to purchase Shire shares, in December of 1999. Prior to that, the defendants had been directors of Roberts Pharmaceutical

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1. As Shire is a only a nominal party in this action, the term "defendants" as used in this opinion refers to the individual defendants.

Appendix C

Company ("Roberts") and had held stock options in Roberts. When Roberts and Shire decided to merge, the two companies agreed that any Roberts options would be converted into Shire options and that certain directors of Roberts, including the individual defendants, would become directors of Shire. Specifically, the Merger Agreement, executed on July 26, 1999, provided in pertinent part:

> At the Effective Time, by virtue of the Merger and without any action on the part of the Holders, each issued and outstanding share of Common Stock . . . together with the associated Right shall be converted into the right to receive from Shire a number of Ordinary Shares (the "Merger Consideration") determined as set forth below (the "Exchange Ratio") . . ."

Merger Agreement, § 2.5.[2] As for the appointment of the defendants as Shire directors, the Agreement provided:

> Shire has agreed . . . to cause . . . John T. Spitznagel, Chief Executive Officer and a director of Roberts, and Dr. Zola Horovitz [and] Ronald Nordmann . . . each a director of Roberts, to be appointed as non-executive directors of Shire following the merger. These appointees will fill five of the eleven directorships which Shire will have immediately after the merger.

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2. Although the Merger Agreement does not specifically refer to stock options, the parties do not dispute that this provision covers stock options as well as shares.

Roberts Proxy Statement at 60.[3] Thus, on the effective date of the merger, December 23, 1999, defendants' Roberts options were converted into Shire options, and they were appointed directors of Shire. Within six months, each of the individual defendants exercised a portion of their options and sold the shares for a profit. The plaintiffs then brought the instant action under 16(b).

The Statute

Section 16(b) of the 1934 Exchange Act prohibits a public company and those who own shares of that company's stock to recover "short-swing" profits realized by an insider "from any purchase and sale, or sale and purchase, of any equity security of [the company] within any period of less than six months." 15 U.S.C. § 78p(b). A statutory insider includes one who "directly or indirectly" owns "more than 10 per centum of any class of any equity security" which is registered under Section 12 of the Exchange Act. *Id.* at § 78p(a). Section 16(b) is a strict liability statute and, as such, "operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition." *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320-21 (2d Cir.1998).

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3. Pursuant to the Merger Agreement, all of the individual defendants acquired their Shire options on December 23, 1999. Zola Horovitz exercised her options on March 8, 2000 and, on March 9, 2000, sold those shares for a profit. Ronald Nordmann exercised his options on March 9, 2000, and, on the same day, sold the shares for a profit. John Spitznagel exercised his options on March 17, 2000, and sold them within six months, the exact date of the sale is unknown.

Appendix C

Strict liability and the penalty of disgorgement are imposed "to remove any temptation for insiders to engage in transactions which 'may serve as a vehicle for the evil which Congress sought to prevent — the realization of short-swing profits based upon access to inside information.' " *Id.* at 320 (quoting *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973).[4]

There are a number of exemptions to Section 16(b) that allow directors to avoid application of the Rule. The three that are relevant here are:

1. the exemption for transactions by a person prior to becoming an officer or director of the issuer (*see* 17 C.F.R. § 240.16a-2(a));

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4. In 1991, the SEC adopted comprehensive amendments to its rules under Section 16(b) under which the acquisition of derivative securities (such as stock options) was held to be equivalent with the acquisition of the underlying securities. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,258 (Feb. 8, 1991) ("Release No. 28,869"). In promulgating the amended rules, the SEC "recognize[d] that holding derivative securities is functionally equivalent to holding the underlying equity securities for purposes of Section 16, since the value of the derivative securities is a function of or related to the value of the underlying equity security." *Id.* The SEC noted that failure to recognize this functional equivalence "would permit insiders to evade disgorgement of short-swing profits simply by buying call options and selling the underlying stock, or buying underlying stock and buying put options." *id.*

2. the exemption for transactions in securities of a foreign private issuer (*see* 17 C.F.R. § 240.3a12-3); and

3. the exemption for transactions approved by an issuer's board of directors (*see* 17 C.F.R. § 240.16b-3(d)(1)).

Oral argument was requested and occurred on June 26, 2001. At the request of plaintiff and with the consent of the defendant, I allowed the plaintiff to pursue limited discovery including a deposition, and this, I was told, would untie the hands of the plaintiff and even the playing field. On July 26, 2001, I held a second argument to allow the parties an opportunity to report on the outcome of the limited discovery and submit any additional argument. Little changed.

DISCUSSION

A claim will be dismissed pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure when "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *See Tarshis v. Riese*, 211 F.3d 30, 35 (2d Cir.2000).

I. The Individual Defendants' Status as Shire Directors

First, defendants contend that their transactions were exempt from Rule 16(b) strict liability as they were not directors of Shire at the time that they acquired the Shire

options. Rule 16a-2(a) provides that a director is not liable under 16(b) for a transaction that took place prior to his or her becoming a director.[5]

Defendants argue that the plain language of the Merger Agreement makes it clear that they became directors only *after* the merger as it lists them under the heading, "Directors of Shire Immediately Following the Merger." They further contend that liability should not be imposed merely because they became directors only a short time, perhaps moments, after acquiring the shares, given the harsh application of the statute.

In response, plaintiffs argue that since these two events took place on the same day they occurred simultaneously as a matter of law. *See* 2 Blackstone Commentaries *141

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5. The Rule reads,

> A transaction carried out by a director or officer in the six months prior to the director or officer becoming subject to section 16 of the Act shall be subject to section 16 of the Act . . . only if . . . the director or officer became subject to section 16 of the Act solely as a result of the issuer registering a class of equity securities pursuant to section 12 of the Act.

See 17 C.F.R. § 16a-2(a) (emphasis added). Thus, the only exception to this rule is if the transaction in question was one in which the issuer was registering securities under section 12 of the Act, which is not the case here.

("[t]he law does not take into account fractions of a day").[6] However, plaintiffs neglect to support application of this hallowed principal in a strict liability context. By contrast, defendants point to a case in which the court did rely upon the sequence of events within one day in concluding that the transaction was covered by this exemption to 16(b). *See Lewis v. Bradley*, 599 F. Supp. 327, 330 (S.D.N.Y. 1984) (declining to impose Section 16 liability where director resigned from issuer's board of directors immediately prior to his sale of issuer's securities, even though both events occurred on the same day); *see generally United States v. Will*, 449 U.S. 200, 225 n.29 (1980) ("[w]henever it becomes important to the ends of justice, or in order to decide upon conflicting interests, the law will look into fractions of a day, as readily as into any other unit of time.").[7]

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6. Plaintiffs also put forth a weak argument that the word "immediately" in Merger Agreement really means "coterminous" and, therefore, that the defendants acquired their shares at the same time as they became directors. Of course, this interpretation ignores the word "following," and it is more than a stretch to conclude that "immediately following" means coterminous.

7. Plaintiffs also argue that, even if the defendants had not been appointed as directors at the time of their acquisition of shares, they were "de facto" directors. Plaintiffs, however, cite no authority for finding a "de facto" director in a 16(b) strict liability scenario or even another similar situation. In fact, it appears that the "de facto" director concept is usually employed in the case of a person who possesses and exercises the power of a corporate office under the claim and color of an election, but, in fact, is not a *de jure* director because of a technical deficiency, *see Prickett v. American Steel & Pump Corp.*, 253 A.2d 86, 88089 (Del. Ch. 1969). Not the case here.

Although there is an admitted dearth of case law supporting either side, defendants have the better argument. I find that defendants fall within this first exemption, and plaintiffs' claims must be dismissed on this ground alone.

II. Shire's Foreign Private Issuer Status

Defendants contend that their transactions were exempt from 16(b) since Shire had foreign private issuer status at the time of the merger.

Rule 3a12-3 provides that all securities registered by a foreign private issuer are exempt from 16(b). *See* 17 C.F.R. § 240.3a12-3. Once again, whether the defendants are covered by this exemption is an issue of timing. It is undisputed that prior to the merger. Shire was a foreign private issuer and that after the merger, it lost that status; the parties dispute, however, whether this status change was effective at the instant of the merger or sometime thereafter.[8]

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8. Under Rule 3a12-3, foreign private issuers are exempt from 16(b). Rule 3b-4 defines a foreign private issuer:

> (c) The term "foreign private issuer" means any foreign issuer other than a foreign government except an issuer meeting the following conditions:
>
> (1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and
>
> (2) Any of the following:
>
> (i) The majority of the executive officers or directors are United States citizens or residents;

(Cont'd)

Appendix C

Defendants contend that Shire did not lose its foreign issuer status until it had an obligation to reassess its status, which occurred *after* the exchange of shares. To support its claim, defendants rely on two SEC No-Action letters.[9] In the first letter, the SEC stated that 16(b) will not apply to director transactions that occur prior to the time the issuer loses its foreign private issuer status. *See Thelen, Marrin, Johnson & Bridges*, SEC No Action Letter, 1994 WL 709723, *1 (December 23, 1994). In the other, *Reed, Elliot, Creech & Roth*, the SEC discussed at what point an issuer is obligated to assess its foreign private issuer status. The SEC concluded that the obligation is not ongoing but, rather, that an issuer must monitor its status at the end of fiscal quarters and "upon completion" of a significant event. *See Reed, Elliot, Creech & Roth*, SEC No-Action Letter, 1993 WL 97704 (March 30, 1993). Thus, defendants argue that these letters should guide the Court to find that Shire was not required to reassess its foreign private issuer status until after the merger was complete and, therefore, the exemption applied.

(Cont'd)

> (ii) more than 50 percent of the assets of the issuer are located in the United States; or
>
> (iii) The business of the issuer is administered principally in the United States.

9. While no-action letters lack precedential value, courts routinely consider the SEC's opinion and may or may not chose to rely on them.

Appendix C

In response, plaintiffs contend that the defendants lost their foreign private issuer status either before or at the instant of the merger due to the fact that the defendants were on notice prior to the merger that Shire would lose its status. To support their claim, plaintiffs refer to the Roberts proxy materials and the Circular that was sent to the shareholders. The proxy material reads in pertinent part,

> Given that Shire anticipates that more than 50% of the combined company's shareholders will be U.S. residents, Shire is likely to lose its foreign registrant status. As a result the SEC will require publication of full U.S. GAAP financial statements in all SEC filings and distributions to U.S. shareholders.

Roberts Proxy Statement at 11. As to the Circular, it reads in relevant part,

> Following Completion, the Enlarged Group will be owned as to approximately 66 per cent by shareholders based in the US, based on the issue of 103,246,272 Consideration Shares. In addition, for the nine months ended 30 September 1999, on a pro forma basis approximately 80 per cent of revenues and substantially all the Enlarged Group's profits were derived from the US operations.

Exhibit B, Plaintiff's Affirmation and Exhibits in Opposition to the Individual Defendants' Motion to Dismiss. Plaintiffs contend that these excerpts demonstrate conclusively that Shire knew that it would lose its foreign private issuer status after the merger.

Even assuming that the plaintiffs are correct, such knowledge is insufficient to cause Shire to lose its status prematurely. Instead, I find that, as the SEC suggested, Shire did not lose its status until its obligation to assess its status arose and that this followed completion of the merger. Shire, so far as I can determine, had no obligation to assess or declare its status earlier, and, thus, the transactions at issue were exempt from 16(b). Therefore, the motion must be granted on this ground as well.

III. Approval by the Board of Directors

Finally, defendants argue that the transaction was exempt from 16(b) since the Shire Board of Directors approved the transaction in the Merger Agreement.

Rule 16b-3(d) exempts any issuer-director transaction that involves a "grant, award or other acquisition [of issuer equity securities] from the issuer" if the "transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors." 17 C.F.R. § 240.16b-3(d)(1). Note 3 to Section 16b-3(d) requires that the board approve "each specific transaction" rather than "a plan in its entirety except for the approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan." *Id.*

Appendix C

The Disclosure Statement,[10] which was approved by the Board as part of the Merger Agreement, identified each holder of Roberts options (including the individual defendants), the number of options that each person held, the date the options were granted, the expiration date, the exercise price of the options and the exchange ratio of Roberts to Shire options. Further, the Merger Agreement contained the terms by which Roberts shares and options would be converted into Shire shares and options pursuant to a pre-determined exchange ratio.

Plaintiffs contend that the Board was also required to state explicitly that its approval was for the purposes of 16(b) exemption in order for the exemption to be effective. To support this interpretation of the Rule, plaintiffs rely upon an SEC No-Action Letter, *Skadden, Arps, Slate, Meagher & Flom LLP*, 1999 WL 11540 (January 12, 1999) in which the SEC stated that in order to exempt a transaction from Rule 16(b), approval by a Board must specify, *inter alia*, that the approval was granted for purposes of exempting the transaction under 16(b). *Id.* at *4. Although I have considered the reasoning in the Skadden letter, I find that it does not accord with the clear language of the statute and decline to follow it. Instead, I find the analysis in *Atlantic Tele-Network v. Prosser*, No. CIV. A. 99-236(SSB), 2000 WL 33310898 (D. Virgin Islands 2000) more convincing. There, the court held, in a fact pattern close to ours, that shares

10. The plaintiffs contend that the Disclosure statement is inadmissible on a motion to dismiss. However, the plaintiffs reference the Disclosure statement in the complaint, and therefore it can be considered by the Court on a motion to dismiss.

acquired in a corporate reorganization that was approved by the board of directors were covered by the 16b-3(d) exemption even if the board had not specified that the approval was for the purposes of 16b exemption. *Id.* at *8 (holding that there is "no requirement in the rule that board approval manifest an intent to exempt the transaction from § 16(b) liability"). I conclude that this decision, along with the plain language of the statute, is persuasive and that the defendants' acquisition of the shares is exempt from 16(b) on this ground as well.

IV. The Acquisition of the Shire Shares as a Purchase Under Section 16(b)

Having found that defendants' motion must be granted, I need not reach their final argument that since they acquired their shares in a merger, the transaction was not a "purchase" under 16(b).

CONCLUSION

For the foregoing reasons, defendants' motion is granted. The clerk is instructed to close the case.

SO ORDERED

New York, New York
August 30, 2001

s/ Harold Baer, Jr.
Honorable Harold Baer, Jr.

APPENDIX D — REGULATION INVOLVED

Employee Benefit Plan Transactions

Reg. § 240.16b-3. (17 C.F.R. Sec. 240.16b-3) Transactions between an issuer and its officers or directors.

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

* * *

(d) *Grants, awards and other acquisitions from the issuer.* Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a

meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; provided that such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

* * *

Notes to § 240.16b-3:

* * *

Note (3): The approval conditions of paragraphs (d)(1), (d)(2) and (e) of this section require the approval of each specific transaction, and are not

satisfied by approval of a plan in its entirety except for the approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan. Where the terms of a subsequent transaction (such as the exercise price of an option, or the provision of an exercise or tax withholding right) are provided for in a transaction as initially approved pursuant to paragraphs (d)(1), (d)(2) or (e), such subsequent transaction shall not require further specific approval.